

ceilings."⁴⁷ While the existing price cap plan has served the public interest, the complexity of the plan limits flexibility and ensures that the plan will not keep pace with the dynamic changes that have taken place in the marketplace. In the remaining parts of this section, NYNEX sets forth the fundamental changes to the Commission's rules required to permit the Commission's regulatory regime to keep pace with these marketplace changes.

1. LECs Must Be Afforded Increased Pricing Flexibility as Competition in Access Markets Increases

The current interstate access structure and rules have changed little since their adoption in 1983. As a result, the Commission's regulations are inconsistent with current competition and technology. The Commission must implement a mechanism to provide NYNEX and the other LECs pricing flexibility commensurate with the level of competition in particular markets.⁴⁸

The USTA Proposal represents an excellent framework for determining when increased pricing flexibility should be permitted in response to competition. USTA's Proposal suggests establishment of a three tier structure consisting of Initial Market Areas ("IMAs"), Transitional Market Areas ("TMAs") and Competitive Market Areas ("CMAs"). In the least competitive

⁴⁷ "Beyond Price Caps: Escaping the Traditional Regulatory Framework," speech by Commissioner Andrew C. Barrett to the Florida Economic Club, August 27, 1992, at p. 1. ("Barrett Speech").

⁴⁸ Transitional Issues 1b, 1c and 2.

areas, IMAs, LECs would be granted 5 percent upward and 10 percent downward pricing flexibility per year, relative to changes in the price cap index. Those wire centers that serve customers that have substitutable services from another source, such as a CAP, cable company or IXC within the geographic area served by the wire center would be classified as TMAs.⁴⁹

Because of the cross-elastic nature of access services, USTA's Proposal provides that all services originating or terminating within these wire centers would be included in the TMA. In TMAs, the 5 percent upward pricing flexibility would remain, but downward flexibility would increase to 15 percent. In addition, once a TMA has been established, LECs would be able to respond to a request for proposal from a customer with a contract tailored to meet the customer's needs.⁵⁰

As the LEC satisfies additional competitive criteria for each TMA, that TMA may be classified as a CMA and the LEC would be afforded even greater pricing flexibility.⁵¹ Rates

⁴⁹ The presence of expanded interconnection in a wire center would automatically satisfy this criterion.

⁵⁰ NYNEX believes that the USTA Proposal, taken as a whole, represents an excellent starting point for reforming the Commission's access charge rules to provide LECs with increased pricing flexibility as competition in access markets increases. At the same time, NYNEX believes it would be reasonable and consistent with the public interest to grant significantly greater flexibility for many services offered in both TMAs and IMAs than is provided for in the USTA Proposal.

⁵¹ The criteria used to certify a wire center as a CMA are: (1) customers in the geographic area served by the wire center can obtain an alternate source of supply for at least 25% of the incumbent LEC's existing access services demand or 20% of the total market demand; and (2)

for services in a CMA would be outside the price cap plan. Market constraints would replace price caps as the mechanism to ensure reasonable rates.⁵² Contract carriage would be permitted for any service in a CMA, and the revenue and cost associated with TMA and CMA contracts would not be included in price cap calculations for establishing average prices.

USTA's three tiered approach to pricing flexibility is a superior alternative to the very limited flexibility available to the LECs under the Commission's current rules. There may be circumstances, however, where an entire study area should be eligible for CMA pricing flexibility. New York is an example of a jurisdiction where a different approach is warranted.

Because of the initiatives by the New York PSC, the regulatory, technical and economic barriers to local exchange competition have been eliminated in New York.⁵³ Indeed, MFS

51 (Footnote Continued From Previous Page)

customers in the geographic area served by the wire center who represent at least 25% of the incumbent's access services demand, or a single customer accounting for at least 15% of access services demand, actively seek to reduce the cost of their access services through the solicitation of bids, private networks or construction of their own access facilities.

52 Services offered in a CMA would, of course, continue to be Title II services. As such, tariff filings would still be required and customers would retain the right to file complaints against carriers whose pricing policies violated the Commission's rules.

53 Since early 1992, Teleport has been disseminating a list of nine "conditions" which they contend must be satisfied for local exchange competition to be operationally, technically and economically feasible. As NYNEX has

and Teleport portray their services as interchangeable with the local exchange services that NYNEX provides to business users in New York. If there are no significant barriers to entry, the market will limit the incumbent's upward pricing flexibility even if competitors have not yet constructed facilities.⁵⁴ For example, in such a market an incumbent, when considering a price increase, will also consider the possibility that a price increase will stimulate entry, and that the presence of the entrants will make any such price increase unsustainable. With all barriers to entry effectively removed, NYNEX's pricing is constrained by the potential for market entry by competitive providers. There is no need to continue to deny customers the benefits that can be achieved by the equal participation of all service providers. CMA treatment should, therefore, be extended to all interstate access services offered by NYNEX in New York.

53 (Footnote Continued From Previous Page)

demonstrated, Teleport now can, or soon will be able to, satisfy each of the nine conditions. See Attachment B, pp. 21-23.

54 Such a market has been described as contestable. See Contestable Markets and the Theory of Industry Structure, Baumol, Panzar and Willig, at pp. 349-350 (1982). "...[A] perfectly contestable economic market is defined to be one into which entry is completely free, from which exit is costless, in which entrants and incumbents compete on completely symmetric terms, and entry is not impeded by fear of retaliatory price alterations... In a contestable market consumers have no preferences among firms except those arising directly from price or quality differences in firms' offerings."

2. The Rules Relating to Price Cap Baskets and Bands Should Be Revised

The current structure of baskets and bands is no longer appropriate. With the changes that have taken place in the marketplace and technology, the Commission's structure of baskets and bands must be revised.⁵⁵

Under the Commission's current rules, the LECs' interstate access services are divided and grouped into four baskets - Common Line, Traffic Sensitive, Trunking and Interexchange. Each basket is generally a grouping of rate elements for similar LEC services or network functionalities. Within each basket, rate elements are subdivided and grouped by service categories, subcategories and density zones. Pricing bands permit prices within service categories to increase or decrease no more than 5 percent per year, adjusted for the change in the price cap index.

The Commission's baskets should group services by functionality. Within those functional baskets, services should be grouped in bands according to the degree of competition that exists for those services. By so doing, the Commission can ensure that appropriate pricing flexibility is available for services within each group and that pricing restrictions can be relaxed as groups of services become subject to increased competition.

With the Commission's recent formation of the Trunking basket, the Commission's current four baskets adequately group

⁵⁵ Baseline Issue 2 and Transitional Issue 3.

services by functionality. Therefore, with minor modification, they should be retained. The four current baskets should, however, be renamed Transport, Switching, Public Policy and Other to more accurately reflect the services contained in each basket.⁵⁶

The Transport basket (currently Trunking) should include all interoffice transport, all entrance facilities and all special access channel termination facilities provided under interstate access tariffs, and any features associated with transport. Switching (currently Traffic Sensitive) should include all switching functions, as well as all features associated with switching. In particular, the switching basket should include the tandem switching rate element, currently included in Trunking, inasmuch as it represents a switching, and not a transport function. The Switching basket should also include the recurring rates for LIDB validation and operator pass-through and the nonrecurring rates for operator services, SS7 signalling and 900 switched services, which are currently included in the Trunking Basket. The Public Policy basket (currently Common Line) would remain unchanged until the Commission determines what additional Public Policy rate elements should be included.⁵⁷ Finally, Other (currently Interexchange) would include interexchange, and any other rate elements which do not clearly fit within the other baskets.

⁵⁶ These are also the names for the baskets suggested by USTA.

⁵⁷ Thus, the Interconnection Charge should, for the time being, remain in the Trunking basket.

The Commission's current price cap categories and bands must be simplified to permit increased pricing flexibility for those categories of services which are subject to competition.⁵⁸ The USTA Proposal would accomplish this goal by grouping or "banding" rate elements within each basket into IMAs and TMAs, thereby permitting increased flexibility based on the level of competition in the particular area. Banding by market area would replace the current system of banding by service categories. Rate elements in CMAs would, in turn, be removed entirely from price cap regulation. NYNEX urges the Commission to implement the USTA approach without further delay.

If the Commission does not adopt the USTA Proposal in this proceeding, there are several changes to the current bands which should be implemented immediately. Specifically, the banding constraints in the Trunking basket should be significantly reduced. The Trunking basket contains the most competitive services, yet also contains the most service categories and subcategories and, hence, the most pricing constraints.⁵⁹ For example, within the High Capacity

⁵⁸ It is important to note that the structure of categories and bands contained in the LEC price cap plan is far more complex than that contained in AT&T's price cap plan. The additional complexity severely restricts the LECs' pricing flexibility at a time when increasing competition dictates that they receive significantly increased flexibility. Attached as Attachment C are charts contrasting the LECs' price cap plan with AT&T's plan at initial implementation, and currently (including the proposed changes to AT&T's plan being considered in Docket 93-197).

⁵⁹ Attachment D is a diagram showing the current Trunking basket.

category, DS1 and DS3 services are contained in separate subcategories. DS1 and DS3 services, however, are both substitutable and subject to intense competition. The LECs should therefore be permitted to price these services without arbitrary banding constraints controlling their relationship.⁶⁰

The number of categories in the Trunking basket should be reduced to two - analog and digital.⁶¹ Analog services use older technology and have experienced declining demand, while digital services have experienced demand growth. Establishing separate analog and digital categories would limit the LECs' ability to shift costs between less competitive and more competitive services, while allowing the necessary increased flexibility within the competitive digital category.⁶² Concerns about geographic price changes within the analog and digital service categories could be alleviated by maintaining subcategories for zones. This would allow

⁶⁰ In several instances, the maze of indices in the Trunking basket has resulted in inefficient pricing. For example, NYNEX has attempted to equalize Switched Direct Trunked Transport ("DTT") rates with corresponding Special Access rates but has been unable to do so because of the limits placed on rates by zones and by the even narrower DS1 and DS3 banding limits. In addition, the banding limits prevented NYNEX from lowering Tandem Switched Transport ("TST") interoffice rates to a level equivalent to the comparable DTT rates in the 1994 annual filing. The restrictive indices and bands prevent LECs from reducing rates to market levels.

⁶¹ The Interconnection Charge would remain as a separate category with its current banding constraints.

⁶² Attachment E shows the proposed bands for the Trunking (Transport) basket.

several different methods for increasing pricing flexibility based on the degree of competition. Increased flexibility, either through wider banding or removal from price cap regulation, could be granted by zone, or for all services in the digital category, as competitive conditions warrant. However, if banding is retained as the price regulation method for all Trunking services, each service category and zone should be banded at plus 5 percent to restrict price increases for any one zone or category and at least minus 15 percent to allow downward flexibility in competitive zones and for digital services.

Although the Traffic Sensitive basket contains switching services which are generally less competitive than the services in the Trunking basket, the bands in the Traffic Sensitive basket are also in need of modification. For example, Billing Name and Address, which is one of the Traffic Sensitive service categories, is a billing and collection service and should not be subject to price cap regulation. Banding limits on the remaining categories, local switching, directory and database, should be modified to permit rate decreases of up to 10 percent without cost support.

3. The Sharing and Low-End Adjustment Mechanisms
Should Be Eliminated

The Commission asks whether the sharing and low-end adjustment mechanisms should be revised or eliminated.⁶³

⁶³ Baseline Issue 4b.

NYNEX believes that the time has come to eliminate these mechanisms.⁶⁴

The Commission acknowledges that the sharing mechanism was originally adopted as a safeguard to permit adjustments if the productivity factor originally determined by the Commission was later found to be incorrect.⁶⁵ In implementing this mechanism, the Commission expressed its desire to balance two competing goals: (1) ensure that LECs share fairly the risks and rewards of productivity gains; and (2) ensure that no individual LEC achieves earnings so low over an extended period of time that the quality of its service and its ability to attract capital is impaired.⁶⁶

NYNEX urges the Commission to eliminate the sharing and low-end adjustment mechanism from the price cap plan. The Commission's current price cap plan is a hybrid between pure price caps and rate of return regulation. With sharing, the LECs are permitted to keep only a fraction of their efficiency gains, thereby seriously dulling the LECs' incentives to improve efficiency.

Sharing has substantially lessened the efficiency incentives of the price cap plan. A recent study estimates that a 4-year price cap regulation plan with a 50/50 sharing

⁶⁴ The Commission also asks how the price cap plan should be revised to support the development of a ubiquitous national information infrastructure. (NPRM at para. 36, Baseline Issue 1a).

⁶⁵ NPRM at para. 47.

⁶⁶ LEC Price Cap Order at para. 121.

mechanism (a plan somewhat more generous to the LECs than the price cap plan currently in effect) has only about 18 percent of the efficiency incentives provided in an unregulated competitive market.⁶⁷ This is not much more than the incentives provided by rate of return regulation over a one year period.⁶⁸ These incentives increase dramatically with the elimination of sharing. For example, the study concludes that a 4-year pure price cap plan provides 35 percent of the efficiency incentives provided in an unregulated competitive market, which is approximately twice the incentives provided by a plan with a 50/50 sharing mechanism.⁶⁹ Incentives continue to increase as the term of the plan is lengthened.⁷⁰

Furthermore, the sharing mechanism will discourage investment in the domestic infrastructure. LECs, like all other businesses, must compete for scarce investment funds. As such, LECs will introduce new services, or undertake network infrastructure projects, only where the anticipated return is commensurate with the risk. Because sharing places a limit on overall return levels, new service offerings and investment projects that carry more than a minimum of risk may be given lower priority by the LEC even though they may otherwise be justified on financial, marketing and technical criteria.

⁶⁷ See "Regulatory Reform for the Information Age", prepared by Strategic Policy Research, Bethesda, Maryland (January 1994) at pp. 22-23 ("SPR Report"). A copy of the SPR Report is attached as Attachment F.

⁶⁸ SPR Report at p. 22.

⁶⁹ Id. at p. 21.

⁷⁰ Ibid.

The sharing mechanism will also encourage investment in the unregulated side of a LEC's business. The sharing mechanism limits the LEC's earnings potential on its regulated investment at a time when investment in new technologies carries increased risk due to uncertain demand for new services and increased competition. If LEC earnings are limited in certain areas of their business, as they are for price cap services under the sharing mechanism, LECs will have an incentive to seek out alternative investment opportunities. To the extent that these investments are made outside the United States, the economic growth of this country could be affected.

Elimination of the sharing and low-end adjustment mechanisms will also remove some of the administrative burden of price cap regulation, thereby increasing efficiency. As markets become more competitive, it will be necessary to remove some services from price cap regulation. With a sharing mechanism, this process will be increasingly difficult. As Commissioner Barrett has recognized:

[A]s long as we impose an overall rate of return ceiling, we must either regulate the prices of all services ... or we must engage in some sort of cost allocation scheme between those services we regulate and those services we don't.

* * * *

However, if we drop the rate of return ceiling while continuing to maintain our ability to regulate prices, we can transition services out of regulation smoothly as they become more competitive. And we can more easily give the carriers additional pricing freedom as competition is developing.⁷¹

⁷¹ Barrett Speech at p. 1.

Thus, sharing greatly diminishes the Commission's ability to account for market changes within the price cap plan. By removing the sharing requirement now, the Commission can begin the transition to a more competitive access market while preserving price regulation as necessary.

Finally, it is important to note that AT&T is subject to a price cap plan that contrasts sharply with that to which the LECs are subject. AT&T's plan contains fewer of the vestiges of rate of return regulation. In particular, the AT&T plan does not now, nor has it ever, contained a sharing or low-end adjustment mechanism.⁷² Despite this fact, AT&T's earnings under price caps have not differed significantly from the earnings achieved by the LECs.⁷³ Furthermore NYNEX's other competitors, the CAPs, other IXC's and cable companies, are not subject to a sharing mechanism, and are thus unencumbered by the disincentives to investment and new service introduction created by this requirement of the current price cap plan.⁷⁴ The Commission should level the regulatory playing field by eliminating the sharing and low-end adjustment mechanisms.

⁷² AT&T has also enjoyed significantly greater pricing flexibility than have the LECs and has been able to introduce new services with fewer regulatory constraints.

⁷³ AT&T Communications' interstate rates of return for the years 1990, 1991, 1992 and 1993 were 13.73%, 13.41%, 12.77% and 13.49%, respectively.

⁷⁴ The Commission's recent Cable Rate Regulation Order, which initiated rate regulation of cable companies, does not include a sharing mechanism. See Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, FCC 94-39, released March 30, 1994 ("Cable Rate Regulation Order"), at paras. 288 and 396.

4. If the Sharing Mechanism Is Retained, No Further "Realignment" With Capital Costs Is Necessary.

The Commission also requests comment as to whether the sharing and low-end adjustment mechanisms should be realigned with capital costs and, if so, how this should be done.⁷⁵ If the Commission retains these mechanisms, there is no need for any realignment.

The Commission suggests that the sharing and low end adjustment mechanisms may not currently be aligned with capital costs because interest rates have declined. The notion that declining interest rates should automatically trigger a reduction in the allowed rate of return is too simplistic.⁷⁶ It ignores, for example, the fact that the fundamental changes that have occurred in the telecommunications industry have led to an increase in the business risk faced by the LECs. Thus, to the extent there is any long term change in the investor's required return, that required return has likely increased, rather than decreased.

The price cap LECs' cost of capital has not necessarily fallen since 1990. As the Commission itself recognizes, "interest rates may also rise as the economy improves."⁷⁷ As widespread press reports have recently noted,

⁷⁵ Baseline Issue 4a.

⁷⁶ NPRM at para. 54.

⁷⁷ Id. at para. 44.

there are mounting indications of a sustained increase in interest rates.⁷⁸

The Commission has made very clear that interest rates bear no necessary relation to capital costs, but are just one of many factors to consider in setting an appropriate rate of return. For example, in its last rate of return represcription case, the Commission refused to increase the rate of return merely because interest rates had increased since the prior prescription. The Commission disagreed with "the view that the cost of equity moves in lockstep with interest rates", and noted it does not employ a simple "risk premium" method of estimating capital costs.⁷⁹

Other factors that enter into Commission determinations of capital costs include Bell Regional Holding Company stock prices. To the extent stock prices are lower - as

⁷⁸ See, e.g., "Stocks Decline Sharply As Interest Rates Jump," The New York Times, March 26, 1994, pp. D1, D38; "Fears Send Markets Plunging," The New York Times, March 25, 1994, pp. D1, D6; "Big Banks Raising Prime Loan Rate By 1/4 Point, to 6 1/4%," The New York Times, March 24, 1994, pp. A1, D16; "Rebound In Interest Rates May Hinder The Recovery," The New York Times, March 14, 1994, pp. A1, D3.

⁷⁹ Represcribing The Authorized Rate Of Return For Interstate Services Of Local Exchange Carriers, 5 FCC Rcd 7507 (1990), Order released December 7, 1990 ("Rate of Return Order"), at paras. 172-73. "Risk premium analyses estimate the cost of equity by adding a risk premium to the current yield on a 'risk-free' investment, such as long-term United States Treasury bonds." Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, CC Docket No. 92-133, Notice Of Proposed Rulemaking And Order, released July 14, 1992 ("Docket 92-133 NPRM & Order") at para. 68.

has been the recent trend⁸⁰ - the higher the cost of equity estimated under the Discounted Cash Flow method employed by the Commission.⁸¹ Further, as competition continues to intensify for NYNEX and other price cap LECs, their business risk will increase. Increased business risk results in increased equity costs and required return.

The Commission has also observed that its prescribed rate of return "is a point within a broad zone of reasonableness".⁸² In the Rate of Return Order, after weighing a "massive" amount of evidence, the Commission identified a "zone of reasonableness" of capital cost estimates and then decided, based on "policy considerations", at what point within that zone to prescribe the return.⁸³ Such policy considerations include the need to preserve carriers' efficiency incentives and spur needed investment in the telecommunications infrastructure - important goals the Commission continues to emphasize.⁸⁴ These considerations would warrant selecting a return from the upper part of the zone of reasonableness. There is no evidence that the 11.25% prescribed rate of return underlying the sharing and low end adjustment mechanisms is not

⁸⁰ See, e.g., New York Times articles cited in fn. 78, supra.

⁸¹ See Docket 92-133 NPRM & Order at para. 54 et seq.

⁸² Id. at para. 97.

⁸³ Rate of Return Order at paras. 2 and 7.

⁸⁴ E.g., NPRM at paras. 1, 5 and 45.

within such a zone of reasonableness. Hence, no realignment of the sharing and low-end adjustment mechanisms is necessary.⁸⁵

5. The Productivity Factor Should Be Reduced

The Commission requests comment on several issues relating to the productivity factor.⁸⁶ Specifically, the Commission requests comment concerning whether the productivity factor used to compute the LEC price cap indices should be changed, or whether, in addition or in the alternative, a one-time change in the LECs' price cap index should be required.⁸⁷ The Commission also asks whether, as one alternative, a mechanism should be adopted to adjust the plan to reflect changes in interest rates. Finally, the Commission asks whether, if the productivity factor should be changed, what method should be used to determine a revised and reasonable productivity factor.

⁸⁵ In any event, if the Commission desired to change the 11.25% rate of return, the Commission would need to follow the procedures required by Section 205 of the Communications Act. See also Part 65 of the Commission's Rules.

⁸⁶ Baseline Issues 3a and 3c.

⁸⁷ Currently, the LECs must meet a substantial productivity benchmark. In the LEC Price Cap Order, the Commission determined that, at a minimum, LECs must achieve efficiency gains that surpass the total of: (1) the economy-wide productivity growth reflected in the GNP-PI (1%); plus (2) the amount by which the telecommunications industry historically exceeded the economy wide productivity growth (2.8%); plus (3) a .5% consumer productivity dividend. Thus, the total current target for the LECs that choose a 3.3% productivity target is actually 4.3%.

The price cap LECs' earnings levels do not warrant either an increase in the price cap formula's productivity factor, or a one-time reduction in rates.⁸⁸ Nor do changes in interest rates justify a change in the productivity factor.⁸⁹ Rather, the only reason that might warrant an adjustment to the productivity factor is a change in the long-term productivity of the LEC industry as a whole. Based on projections of the long-term productivity of the LEC industry, the productivity factor should be reduced.

The most appropriate and accurate way to determine LEC industry productivity is to utilize a total factor productivity ("TFP") methodology which uses direct and observable measures of industry inputs and outputs.⁹⁰ A TFP methodology determines productivity using total company and industry financial and accounting data to compute the growth in economic

88 See Section II(A), supra.

89 See Section II(C)(4), supra. A study prepared for USTA by National Economic Research Associates, Inc., entitled "Economic Performance of the LEC Price Cap Plan" ("NERA Study") confirms that the price cap plan fully accounts for any changes in interest rates and that a rate adjustment to account for interest rate changes is therefore unnecessary. See NERA Study at pp. 25-28. A copy of the NERA Study is attached as Attachment G.

90 The Frentrop/Uretsky study and the Spavins/Lande study, the two principal productivity studies relied on by the Commission in setting the current LEC productivity factor, were both based on indirect measurements. See LEC Price Cap Order at 6796, n.88 and Appendices C and D. A significant problem with indirect studies is that underlying LEC data reflects capital costs based on the Commission-prescribed depreciation schedules, rather than actual economic-based asset lives. This results in less accuracy in the productivity measure. A TFP study uses an estimate of capital input which more accurately reflects the economic life of capital assets.

efficiency of production. In order to determine an appropriate productivity factor for the price cap formula, NYNEX, in cooperation with USTA, commissioned a TFP study by Christensen Associates.⁹¹ The Christensen Study was designed to determine the TFP growth rate of the price cap LECs for the 1984-1992 period. For the Christensen Study, total outputs, which consisted of revenues for all services provided by the LECs (total operating revenue as defined in Form M), were measured adjusted for price changes. Output was measured for seven different types of services: (1) local service; (2) interstate end user access; (3) interstate switched access; (4) interstate special access; (5) intrastate access; (6) long distance service; and (7) miscellaneous services. Inputs consisted of capital, labor, and materials that were used to provide those services. The Christensen Study measures the TFP growth; that is, the rate of growth of outputs minus the rate of growth of inputs. The study results are clearly representative, in that a large number of industry members participated.⁹² Moreover, the data used for the study were

91 Christensen Associates, "Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation" (April 25, 1994), Laurits R. Christensen, Philip E. Shoech, and Mark Meitzen. ("Christensen Study") A copy of the study is attached as Attachment H.

92 The companies included in the study were the seven Regional Bell Operating Companies, GTE and Southern New England Telephone Company.

derived from company records, most of which are filed annually with the Commission.⁹³

The Christensen Study shows that over the 1984-1992 period, total output for the price cap LECs grew at a 3.5 percent average annual rate and total input grew at a 0.9 percent average annual rate, yielding an average annual TFP growth rate of 2.6 percent.⁹⁴ Because the productivity offset in the price cap formula is related to the differential in productivity growth between the price cap LECs and the U.S. economy as a whole, Christensen also calculated the difference between the price cap LECs' TFP growth rate and the TFP growth rate for the U.S. private business sector that is published by the Bureau of Labor Statistics, which is the most comprehensive TFP measurement available.⁹⁵ This TFP differential is 1.7% (2.6% less 0.9%).⁹⁶

The Christensen Study also shows that the trend in the overall total output growth rate for the price cap LECs has been downward. In particular, the total output growth rate for

93 Furthermore, the NERA Study confirms that TFP is the only appropriate measure of productivity growth. NERA concludes that use of TFP in setting a productivity target avoids distortions in the incentives of the firm. NERA also concludes that, given the structure of the annual price cap adjustment formula, only total factor productivity can be used to set the productivity target. See NERA Report at p. 18.

94 Christensen Study at p. 11.

95 The TFP growth rate for the private business sector is for the years 1984 through 1990, the latest figures available. See Christensen Study at p. 12.

96 Christensen Study at p. 12.

1991 and 1992, the two years under price cap regulation, showed a lower growth rate than for any of the previous years.⁹⁷

The corresponding TFP growth did not show a similar decline for the same time periods only because of additional cost reductions undertaken by the companies, particularly reductions in labor costs, which reduced input growth. Clearly, these declines in input growth rates, which essentially reflect one-time cost reductions for labor, cannot be sustained.

The Christensen study also examines the possible future impact on the LECs' TFP of increasing access competition. Christensen notes that TFP growth can arise from various sources. One primary source of TFP growth is output growth. Prior to divestiture, the telephone industry experienced rapid rates of output growth, and econometric studies of the industry showed that this output growth contributed significantly to TFP growth. Since divestiture, the LECs have experienced more modest rates of output growth, and with emerging competition, they face the prospect of even slower output growth.⁹⁸

Moreover, growth in high margin services contributes more to TFP growth than growth in low margin services. Conversely, reductions in growth in high margin services leads to disproportionate reductions in TFP growth. Much of the

⁹⁷ Christensen Study at page 13, Table 1. The growth rate for total output for 1991 and 1992 respectively was 2.3% and 2.1% while the growth rates ranged from 3.0% to 5.0% for the previous years covered in the study.

⁹⁸ See Christensen Study at pp. 24-25.

competition from CAPs is focused in markets with high margins. Increasing competition will surely lead to a decline in LEC market share for these services which will, in turn, lead to a lower LEC TFP.⁹⁹

Furthermore, the .5 percent consumer productivity dividend included in the calculation of the productivity factor is unnecessary and should be eliminated. The inclusion of a consumer productivity dividend constitutes an unnecessary departure from the investment and efficiency incentives that exist in competitive markets, where firms do not usually share the benefits of above average productivity performance with their customers.¹⁰⁰

⁹⁹ For example, Christensen notes that a one percentage point decrease in output will lead to a reduction in TFP growth of between .3 and .5 percentage points. (Christensen Study at p. 25).

¹⁰⁰ Finally, revision of the productivity factor is clearly warranted in light of the Commission's recent actions in connection with cable rate regulation. In its Cable Rate Regulation Order, the Commission adopted a price cap system for cable rate regulation "similar in many respects to the price cap system . . . adopted for the telephone industry." The initial price cap plan for cable companies, however, does not include a productivity factor, and, in its Further Notice of Proposed Rulemaking, the Commission has suggested a productivity factor for cable companies of only 2 percent. In formulating its proposal, the Commission noted "that cable operators should reasonably be expected to achieve productivity gains in the future analogous to those historically realized by other communications firms." Id. at para. 319. The Commission also stated that "[c]able television networks are similar in many ways to telephone networks," and that both are likely to benefit from the advances in technology, "especially as cable and television networks coverage." Id. Nevertheless, the Commission recommended a cable productivity factor which is significantly lower than the current 3.3

Thus, a properly calculated productivity factor, based on a long-term TFP analysis, demonstrates that the current 3.3% productivity factor (including the .5% consumer productivity dividend) is unreasonably high. The Commission should set the productivity factor at no higher than 1.7%. Moreover, as explained above, the 1.7% factor will likely overstate long-term LEC productivity as competition continues to expand in LEC access markets.

6. The FCC Should Streamline Its New Services Rules

The Commission's new services rules inhibit the introduction of new and innovative services.¹⁰¹ As such, they should be modified. The modifications should reflect two basic principles. First, LECs must be able to make offerings in a timely manner, with minimal regulatory uncertainty. Second, LECs must be able to set prices for new services which reflect market realities. LECs must be afforded the

100 (Footnote Continued From Previous Page)

percent LEC offset, citing the fact that "local telephone companies have benefitted from advances in computerized local switches, which are not in general used by cable systems." *Id.* Contrary to the Commission's reasoning, cable companies are well positioned to achieve substantial productivity gains as they continue to convert to the digital technologies that LECs have already installed. The Commission's action in proposing a far lower productivity factor for cable companies than for the LECs is arbitrary, and potentially places the LECs at a significant competitive disadvantage.

101 The Commission requests comment concerning whether the LEC price cap new services requirements impose unnecessary impediments to the development and introduction of new services and, if so, how the rules should be modified. Baseline Issue 8a.

opportunity, like their competitors, to generate earnings commensurate with the risk and market value of new offerings.¹⁰²

The Commission's procedural rules unnecessarily delay the introduction of new services. The notice requirements for tariff filings are too lengthy; at best, new services can be introduced no earlier than 45 days from filing. The effective date of a new service offering can be delayed for up to 120 days at the Commission's discretion. Moreover, the rules provide LEC competitors with an unfair advantage by giving them lengthy advance notice of LEC offerings, and the opportunity to seek delay of LEC offerings through the intervention process. In stark contrast to price cap LECs, CAPs can file their new competitive services on only one day's notice, and without any tariff justification or support.

Service innovation is also discouraged by the Commission's cost support requirements for new services. These requirements generate delay, consume LEC and Commission resources and inhibit the development of competition by requiring LECs to reveal valuable cost data to competitors.¹⁰³

The most significant impediment to the introduction of innovative new services is the current constraint on the

102 The FCC's current regulations generally provide that rates for new services may not exceed fully distributed costs, i.e. direct costs plus allocated overhead costs plus an 11.25% return on net investment. See NPRM at paras. 74-76.

103 NPRM at para. 79.

maximum rates LECs can charge for new services. The price "ceiling" is not only unnecessary in many instances but, more importantly, significantly impedes the development and introduction of new innovative, high-risk services.

The LEC Price Cap Order did not constrain the maximum prices LECs could charge for new services. However, upon reconsideration, the Commission adopted fully distributed costs as a ceiling constraint based on the view that LECs enjoy substantial market power.¹⁰⁴ In view of changing market conditions, and the Commission's desire to further promote the introduction of new services, the Commission should return to its original approach and remove the current price ceiling constraint on LEC new services.

Furthermore, mandated price ceilings are unnecessary when the new services are variations - either in pricing, technology, or features - of existing services. The prices of existing LEC services, and those of competitors' services which are substitutes or alternatives, provide market-based benchmarks for similar new services. LEC customers are not forced to buy the new services, but may choose to buy them based on the differences in price and value. The LEC must be allowed to determine the appropriate market price. If the LEC prices a new service higher than the market value, customers will not buy the new service, but rather continue with their existing service. On the other hand, if the LEC prices the new

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See LEC Price Cap Reconsideration Order, 6 FCC Rcd 2637 (1991), at para. 126.